

# **THE RICHEBÄCHER LETTER**

*Monthly Analysis of Currencies and Credit Markets*

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**Excessive debt accumulation, with the relatively weakest economic units often most heavily loaded, was, of course, the reciprocal of the credit expansion that “heated” the prosperity. It was a prime ingredient in the financial condition that was to overtake a large sector of the economic system: illiquidity. It was, indeed, an illiquid, overexpanded colossus of debts, rather than an excessive money supply, on which the price structure of the late 1920s rested.**

— Melchior Palyi, *The Twilight of Gold, 1914–1936*, 1972

## **REALITY CHECK**

How time flies. Half of 2004 has already passed. When it started, optimism was running high for both the markets and major economies, the U.S. economy in particular. Playing the “Great Reflation Trade” in bonds, stocks and commodities was the order of the day.

All the trades have turned into disappointments. Remarkably, equity markets were the first to stop their bull run in late January. Looking back to the start of the year, stocks worldwide have more or less been treading water. We guess it is the first time in history that a strong economic recovery is lacking the company of sharply rising stock prices. It is very strange, to be sure.

Wall Street’s favored argument is that stocks have been temporarily oversold. Persistently thin turnover, however, rather suggests indecision among investors. The steady flow of economic data is mostly positive, but definitely not exciting enough to confirm a truly strong and sustained recovery. Thus, few buyers meet few sellers.

Sustained or aborted recovery is manifestly the all-important question at this juncture. With this question in mind, we undertake a thorough reality check of the U.S. economy in this letter.

For the optimists, the sharp jump of real GDP growth in the third quarter of last year was the start of the “robust, sustained” recovery they want to see. Observing that the big jump in GDP growth during the third quarter was followed by steep falls in just those demand components that normally lead a recovery, we had to draw the conclusion that the unusually massive monetary and fiscal stimulus of 2003 had totally failed in its main task to implement a robust, sustained recovery. The pattern of this expansion bears no relationship whatsoever with the pattern of healthy, sustained expansions in the past.

But our negative assessment of the U.S. economy’s further growth prospects has a second very strong reason. It concerns policies and the changes that have occurred in America’s credit and asset bubble system.

The motor of U.S. economic growth in the past three years was an extraordinary consumer borrowing-and-spending binge that got its fuel from the confluence of no less than four different, yet closely correlated, asset and credit bubbles — bonds, stocks, housing and mortgage refinancing. Of these bubbles, the two most important ones for the consumer borrowing-and-spending binge — bonds and mortgage refinancing — have been badly damaged.

Recent events confirm that the Greenspan Fed, with its preposterous money and credit creation, has in reality lost control. The sharp rise in long-term bond yields that virtually closed the mortgage-refinancing window to the consumer was clearly against its wishes and intentions. In essence, its policies have boiled down to steering the economy through manipulating the markets and their prices. Measured by the resulting consumer borrowing and spending binge, this policy may appear a success. Without the bubbles, very little would probably have happened in the economy. But with the sharp rise of long-term interest rates in April–May, this policy went badly wrong — and will be wrong for a long time to come.

In recent Senate testimony, Fed Chairman Alan Greenspan made some remarks about the intricacies of monetary policy that make one wonder whether they come from the chief of a central bank or from that of a hedge fund:

*"The Federal Reserve's experiences over the past two decades make it clear that such uncertainty is not just a pervasive feature of the monetary policy landscape; it is the defining characteristic of that landscape. As a consequence, the conduct of monetary policy in the United States has come to involve, at its core, crucial elements of risk management. The conceptual framework emphasizes understanding the many sources of risk and uncertainty that policymakers face, quantifying those risks when possible and assessing the costs associated with each of the risks."*

That sounds extremely sophisticated. In reality, it reveals a central banker who has completely lost sight of his true task — to guard macroeconomic growth and macroeconomic balance.

UNITED STATES: PHYSIOGNOMY OF THE 2003–04 UPSWING PERCENT CHANGE FROM PRECEDING PERIOD					
	2003				2004
	I	II	III	IV	I
<b>GROSS DOMESTIC PRODUCT</b>	2.0	3.1	8.2	4.1	4.4
<b>PERSONAL CONSUMPTION</b>	2.5	3.3	6.9	3.2	3.9
DURABLE GOODS	0.5	17.7	28.0	0.7	-4.2
NONDURABLE GOODS	5.7	1.2	7.3	5.4	6.6
SERVICES	1.5	1.7	2.8	2.8	4.2
<b>GROSS PRIVATE FIXED INVESTMENT</b>	1.1	6.1	15.8	9.9	5.1
NONRESIDENTIAL	-0.6	7.0	12.8	10.9	5.8
STRUCTURES	-4.0	3.5	-1.8	-1.4	-7.0
EQUIPMENT AND SOFTWARE	0.5	8.0	17.6	14.9	9.8
RESIDENTIAL	4.5	4.5	21.9	7.9	3.8
<b>FEDERAL GOVERNMENT</b>	-0.2	23.5	1.2	0.7	9.2

SOURCE: BUREAU OF ECONOMIC ANALYSIS, TABLE 1.1.1. ALL NUMBERS SEASONALLY ADJUSTED AT ANNUAL RATE.

The above table attests in detail to the U.S. economy's pattern of growth during 2003 and in 2004's first quarter. Attaching greatest importance to any changes in the composition of demand and output, in our view such itemized analysis is absolutely indispensable for serious economic research. It strikes us, on the other hand, that American consensus economists take very little or no interest at all in these details. It is one major reason for our disagreements, both past and present.

For the optimistic consensus, expecting and forecasting further strong above-trend growth for the U.S. economy starts with the conviction that last year's massive monetary and fiscal stimulus has imparted to the U.S. economy enough traction for sustained, robust economic growth as far as the eye can see. Understandably, this comforting notion has found easy and quick acceptance around the world.

We cannot agree with this view mainly for two reasons: *first*, the asset and credit bubbles — stocks, bonds, housing and mortgage refinancing — that have propelled U.S. economic growth during recent years have manifestly lost their power; and *second*, overwhelming statistical evidence suggests that last year's economic recovery started and peaked with the strong third quarter.

## **THE FOUR "DYNAMICS"**

It is established experience that the business cycle's ups and downs accrue mainly from the fluctuations of four GDP components: consumer durables, residential building, business fixed investment and business inventories. In essence, they are the key variables, or "dynamics," in the business cycle. Consumer spending on nondurable goods and services also rises and falls, but far less in proportion. What's more, it does so largely in response to the income creation from those four "dynamic" components.

Over the past weeks and months, we have been reading with growing amazement more and more euphoric reports about the U.S. economy, claiming a firmly established, robust expansion, together with a booming China, propelling a strong worldwide economic recovery. There appears to prevail a general comforting assumption that the “true” recovery associated with strong employment growth has only been delayed, and that it is sure to follow.

Please return to the prior table and take a keen look at those components that we have identified as the key variables or inherent “dynamics” of the business cycle. The growth rate of consumer spending on durables has literally collapsed from a stellar 28% in the third quarter of 2003 to negative 4.2% in the first quarter. The growth rate for residential building has plunged over the same period from 21.9% to 3.8%, and for business investment in equipment and software from 17.6% to 9.8%.

Putting it differently, these three key dynamic GDP components accounted for 4.58 percentage points of the recorded real GDP growth in the third quarter of 2003. In the first quarter of 2004, their contribution was steeply down to just 0.60 percentage points. We would say calling this a spending collapse is no exaggeration.

To be sure, spending has not declined. Prior steep growth has flattened out. For comfort, it is often argued that spending, nevertheless, remains on a high level. For the time being, that is true, but this argument completely misses the crucial point that spending at a high level is not enough to accomplish economic growth. What alone adds to GDP are new increases in spending. In the 1920s, by the way, residential building reached its high point, as early as 1925, and remained at a high level until 1928. Its precipitous drop happened in 1929, prior to the general economic collapse.

## **AN EMPLOYMENT DISASTER**

Over time, we have learned the hard way that there can be enormous differences between prevailing perceptions about something and its reality. What, really, are the assumptions behind the highly optimistic forecasts for the U.S. economy’s prospects? We see economists grabbing at the rare strong economic data that seem to confirm these forecasts. What we do not see is stringent, comprehensive analysis in the way of putting together a jigsaw puzzle. Wall Street, the media and the public want news that makes headline numbers. More or less, that is what passes for economic discussion today, and not just in the United States.

So what is the meat behind the optimistic U.S. economic forecasts? Early this year, the markets had actually begun to become a bit doubtful about the U.S. economy’s continuous strong growth. In apparent response, the stock market’s advance suddenly halted, while the euro strengthened.

But market sentiment abruptly and drastically changed on one single day, May 7, when the Labor Department reported a totally unexpected big jump in employment by 337,000 for March, associated with upward revisions for the prior months.

Following more than three years of disastrous employment numbers, this was sensationally good news. The consensus jumped to the conclusion that the definite turnaround in the employment performance had arrived. Further stellar employment numbers for April and May essentially strengthened this conviction.

Realizing first of all that these exciting employment data were totally out of whack with most other current U.S. economic data, we decided to do a close investigation. The first, and a very big, stumbling block was, of course, the sudden steep rise of the “net birth/death” adjustment, which we commented on in the last two letters.

In May, by the way, this stroke of the pen contributed no less than 195,000 new jobs to the reported overall increase of 248,000. Of the 947,000 new jobs that the Bureau of Labor Statistics (BLS) counted for the three months March–May, the net birth/death adjustment has accounted for 618,000, or two-thirds, of the total.

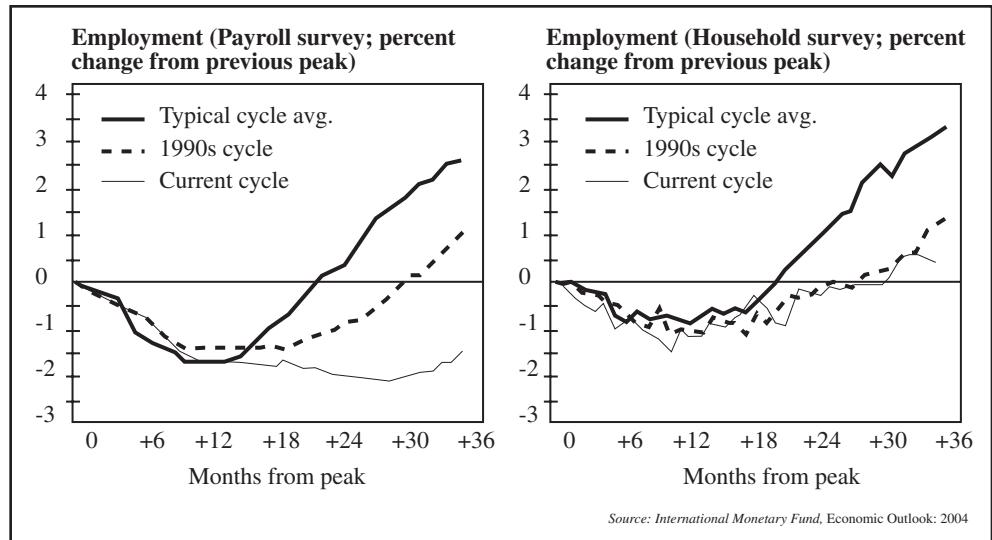
In its most recent report, the BLS explained in detail the computer model with which it calculates these numbers. It was incomprehensible statisticians’ language that did not even try to make economic sense. What truly matters, of course, is not the sophistication of the computer model, but the good or bad sense of the underlying economic assumptions. Some elucidation about those assumptions would make sense. With or without computers, statistics precisely give back what has been put in.

Lacking a reasonable economic explanation, we regard those big B/D numbers of the last few months as no

more than crude estimates reflecting simply the prevailing generally great optimism about the U.S. economy. For the rest we stick to stringent analysis of past and forthcoming economic data. Besides, considering rising inflation rates, growth in real wage income remains most disappointing, despite the well-advertised pickup in job creation.

The fact is that U.S. employment performance during the past few years has been unique in its severity for the postwar period, and it is equally unique in comparison with the employment performance in the rest of the world.

It is now two-and-a-half years since the U.S. recession officially started, in late 2000. At the time nonagricultural employment amounted to 132.3 million. If employment had risen in line with past cyclical recoveries, by now it would be more than 7 million higher. Instead, it is still down well over 1 million.



## THE MAIN VICTIM: INDUSTRIAL PRODUCTION

Yet the worst part of this employment disaster is centered in the manufacturing sector. Employment there has plunged from 17.3 million to 14.3 million in three years. This, too, finds very little or no attention.

Drastically strangled industrial production is effectively at the heart of America's economic quagmire. From 1997–2003, U.S. industrial production rose a mere 12%, or 2% per year, as measured against an overall increase of real GDP by 25%, or 4% per year.

What's more, the increase in manufacturing overwhelmingly accrued from hedonic pricing of computers, communication equipment and semiconductors. Excluding these components, industrial production in the fourth quarter of 2003 was barely at its 1997 level.

Job destruction essentially implies corresponding income destruction. Incomes from wages and salaries in the private sector in 2002–03 increased 3.5% before inflation. In real terms, that is little more than stagnation.

To put this into perspective: During the comparable first two years following postwar recessions, the growth rate of real wage and salary income averaged 9%. It goes without saying that this rapid real income growth played the key role in driving the economy's recovery.

## ILLUSIONS ABOUT FIRST QUARTER 2004

In its last *World Economic Outlook*, the International Monetary Fund (IMF) ponders the causes for this disastrous job performance in the United States, mentioning changes in the utilization of labor to lower costs and improve productivity, the backdrop of geopolitical uncertainties and terrorist threats as possible reasons that may have induced firms to “*delay hiring until the recovery is firmly established.*”

In conclusion, it says: “*These factors, however, are likely to have delayed rather than negated the usual cyclical recovery in the labor market.*” Yet it ends the chapter with the reservation, “*If employment does not pick up as expected, however, this would have significant implications for the sustainability of the recovery.*”

Nonetheless, the IMF states as a matter of fact that “*Growth in the United States Surges.*” Actually, it revised its real GDP forecast for 2004 from 3.1% to 4.6%. The common popular arguments behind the increasingly optimistic

growth forecasts are profits “close to record levels,” falling labor costs and rising inflation rates giving more pricing power.

With reported 4.4% real GDP growth in the first quarter, economic activity certainly gave the appearance of acceleration. On closer examination, we noted that it had gathered major contributions from inventory building and government spending, accounting together for 1.3 percentage points of the reported real GDP growth.

Next we stumbled over a big difference between the strong quarterly GDP numbers for consumer spending and very weak monthly numbers, as reported by the same government agency, the Bureau of Economic Analysis (BEA), in a separate report: Personal Income and Outlays, published every month.

According to the GDP accounts, consumer spending in the first quarter of 2004 grew by \$71.1 billion, up from \$59.6 billion in the prior fourth quarter of 2003. But the monthly reports showed a radically different picture. By these numbers, consumer spending during the quarter increased only \$45.1 billion, following a steep rise by \$97.1 billion in the prior quarter.

As explained in the last letter, the reason for the big difference between the two calculations is no mystery. The GDP numbers measure the changes in quarterly averages, while the monthly reported numbers measure the changes in spending within the quarter from month to month.

The most up-to-date numbers are manifestly found in the month-to-month reports. Including April, they show consumer spending at its weakest in years. By the GDP numbers, consumer spending contributed 2.71 percentage points to the first quarter’s real growth. By the month-to-month measure, it was 1.3 percentage points.

Considering in addition the earlier mentioned slumping growth in residential building and business fixed investment, we actually see the U.S. economic recovery in immediate danger of aborting. The highly optimistic growth forecasts are built on the conviction that lagging business investment is catching up with still-strong consumer spending. Our analysis tells us that consumer retrenchment is catching up with weak business investment.

All in all, these facts just described are absolutely compelling evidence for us of a rapidly weakening U.S. economy. Yet two other considerations strongly confirm this critical assessment. The one concerns so-called “pent-up” demand and the other negative implications for the further workings of the asset and credit bubbles.

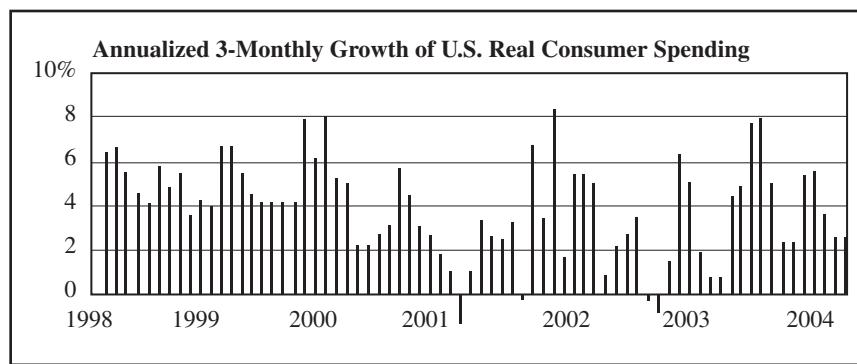
## **MISSING PENT-UP DEMAND**

Again at issue are the demand components of which we earlier spoke as the “dynamics” in the business cycle: consumer durables, residential building, business capital expenditures and, as the fourth, business inventories.

The decisive common denominator is their high propensity for credit financing. When monetary policy tightens, they bear the brunt of the pain, and when monetary policy eases, they enjoy the brunt of the benefits from the following strong economic rebound.

The fact to see is that monetary tightening, by imposing a credit crunch on the economy, implicitly creates in step with the recession an accumulation of pent-up demand. Just as implicitly, the later monetary easing has regularly unleashed a virtual burst of this pent-up demand. Actually, this was the key factor behind the famous V-shaped economic recoveries, as the existence of such pent-up demand was always crucial for the enormous thrust of the following recoveries.

But this time, there is no such pent-up demand. Instead of the usual monetary tightness and high interest rates,



there has been unprecedented monetary looseness with rock-bottom interest rates. Instead of a credit crunch, pent-up demand and ultra-loose and ultra-cheap credit generated unbelievable spending excess. In short, the consumer has borrowed and spent as never before, at the expense of his future purchases.

For sure, this moderated the recession. But in the same vein, it has not created the pent-up demand that it vitally needs for the following recovery. According to a study published in 1993 by the New York Fed, during the first two years of past recoveries, residential investment, on average and in the aggregate, has surged by 36.7% and business investment in equipment by 21.4%

In fact, the extremely loose monetary policy has had the diametrically opposite effect of pulling future demand to the present. Real GDP since 2000 is up 6%. Consumer spending on durables soared over this time by 24%. Residential building, with a rise by 18%, was, not surprisingly, second in speed of growth. Nonresidential investment, on the other hand, is down 5%. Exports of goods lost 4%, while imports of goods gained 9%.

## **PRICKED BUBBLES**

During the boom years of the late 1990s, the U.S. economy got its strongest impetus from the unfolding stock market bubble. Feeling richer from soaring stock prices, the consumer slashed his savings from earned income to the bone. The result was accelerating economic growth with a rising share of personal consumption.

When the stock market went into its protracted slump in 2000, the Fed succeeded in maintaining the consumer borrowing and spending binge through orchestrating a variety of four different asset and credit bubbles — bonds, stocks, housing and mortgage refinancing.

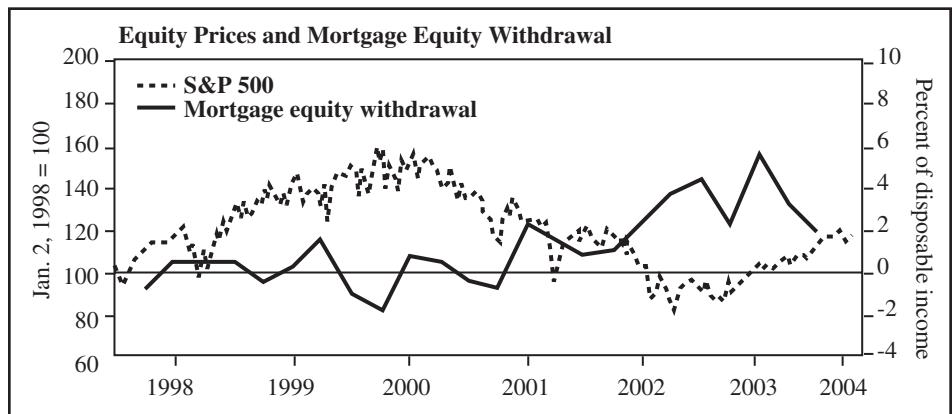
With persistent public assurances to keep its short-term interest rate locked at its ultra-low levels, the Fed lured America's powerful army of financial institutions into the highly leveraged carry trade of bonds. By driving long-term rates in this way to rock-bottom postwar levels, the developing huge bond bubble, in turn, implicated a roaring housing and mortgage-refinancing boom on the part of private households.

Taking advantage of rock-bottom interest rates, rising house prices and an unprecedented largess of lenders, American homeowners embarked on a record mortgage-refinancing bonanza, literally monetizing their houses. In 2003, personal mortgage borrowing rose by \$758.1 billion. Judging from the difference between total borrowing and net investment in residential building, about \$550 billion of the borrowed money was for equity extraction.

But asset and credit bubbles, implicitly, pop one day. That day arrives when interest rates increase. Until quite recently, market opinion expected no rate hike until after the presidential election in November. True, the Federal Reserve had softened its promise of no rate hike in the foreseeable future into the promise of "measured" steps to be taken with "patience." It sounded not very different from the earlier formulation.

Yet Mr. Greenspan and his crew suddenly started to warn in public speeches about a looming inflation risk, hinting at a possible need to raise interest rates. Speaking on June 8, 2004, via satellite to the International Monetary Conference in London, he made some remarks conveying an impression of urgency:

*"Lastly, let me emphasize that recent financial indicators, including rapid growth of the money supply, underscore that the FOMC has provided ample liquidity to the financial system that will become increasingly unnecessary over time. The Committee is of the view, as you know, that monetary policy accommodation can be*



*removed at a pace that is likely to be measured. That conclusion is based on our current best judgment of how economic and financial forces will evolve in the months and quarters ahead. Should that judgment prove misplaced, however, the FOMC is prepared to do what is required to fulfill our obligations to achieve the maintenance of price stability so as to ensure maximum sustainable economic growth."*

To us, the remark of a central banker to do "what is required" is, frankly speaking, no more than a platitude. Is that not his obvious duty? Yet the financial markets interpreted it as the announcement of an imminent major shift in monetary policy from fighting deflation to fighting inflation.

It has always been our contention that Mr. Greenspan is desperate to maintain his various asset and credit bubbles until employment and income growth take over. For those who believe in the genuineness of the "net birth/death" adjustment, this shift may have started. For those who doubt its authenticity, the worst for the U.S. economy has yet to come. (Employment, by the way, is implicitly a lagging indicator.)

Wondering what really triggered this sudden shift in emphasis toward stressing the risk of inflation, it struck us as rather strange that top Fed officials were making these hawkish statements even though drastic credit tightening had, in effect, been put in place not by the Fed, but by the bond market.

## A MOST SAVAGE CREDIT CRUNCH

While the Fed may hike its rate by one quarter or one-half percentage point, the bond market had used a hammer, raising 10-year Treasury yields by 100 basis points within just two weeks — that is, by nearly a full percentage point.

If the Fed truly and urgently wanted credit restraint, the action in the bond market should have pleased them. We suspect the abrupt surge of long-term rates has shocked them, because the resulting higher mortgage rates have effectively choked the mortgage refinancing bubble, presenting policymakers in the Fed with far more credit tightening than they really want.

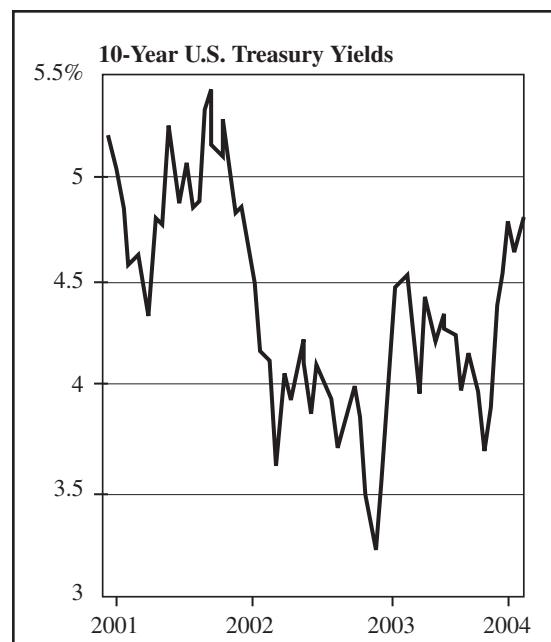
All their hawkish talk, we presume, was intended rather to calm the inflation fears in the market by emphasizing the Fed's anti-inflation vigilance, thereby hopefully moderating the rise in longer-term market rates. In any case, the talk about a rate hike was much ado about nothing.

In his London speech, Greenspan cited that "*the rise in rates... has induced a dramatic fall in mortgage refinancing.*" According to the Mortgage Bankers Association (MBA), mortgage financing activity in the United States in the week ending June 4 was down 68% compared to a year ago. The MBA's Refinancing Index had even plunged by 85% year over year.

Yet the impact of the higher interest rates seems to have been cushioned by a surge in the demand for adjustable rate mortgages (ARMs).

What exactly could or would the Fed accomplish with a quarter-point rate hike? What would that do to the economy and the financial system? In short, it would not be likely to change much, if anything at all. Even the carry trade would still be profitable at this higher rate.

In fact, the existing short-term rate of 1% is ridiculously low for a supposedly booming economy to begin with. But most of the profits derived from this record-low rate go to the financial system, funding its assets in large part by this rate. Manifestly, Wall Street firms, banks and hedge funds could easily cope with a slightly higher federal funds rate. For consumers and nonfinancial firms, the Fed's 1% rate is pure theory — except for savers.



What truly matter, in particular for financial institutions heavily engaged in carry trade, are changes in the long-term rate, because they directly hit their capital, and that, of course, with high leverage. The rise by 100 basis points that has happened reduces the value of 10-year bonds by almost 10%. Given that carry trade with bonds is generally leveraged at 20:1, or 5% equity, this loss of value in the bond holdings actually wipes out more than the invested capital.

In hindsight, it seems reasonable to say that by maintaining the consumer borrowing and spending binge in the face of plummeting income growth, the mortgage-refinancing bubble has been the U.S. economy's lifeline. Consumer spending posted a new historical record in the sense that it outpaced total economic growth. With an overall increase of \$625.8 billion, for the first time in history it exceeded the simultaneous GDP growth, up \$581 billion. The consumer achieved this with a debt surge of \$1,678.8 billion.

But as explained, this lifeline has been badly damaged. There is no spectacular collapse like that in the stock market of 2000–01. Yet a drastically deflating mortgage-refinancing bubble is sure to have a much greater effect on the economy. What is unfolding there is not just gradual credit restraint. It is a most savage credit crunch with obvious, most dismal consequences for consumer spending and the economy.

All the more, it stuns us how little attention this fact is finding. Just weeks ago, the question of a possible quarter-point rate hike by the Fed provoked an agitated public discussion. Now there appears to be a savage credit crunch in the offing, and nobody seems to even notice.

In our view, the fate of the mortgage refinancing bubble and its further impact on the economy is presently the single-most important issue facing the U.S. economy. All other major GDP components are much too weak to take over as the new locomotive. Consider that nonresidential business investment contributed just 0.30 percentage points to real GDP growth in the first quarter of 2004. Consumer spending remains so predominant that any weakness on its part would instead pull down the other components.

Of the numerous economic data that America's statisticians constantly publish, a single forthcoming number appears absolutely decisive under these circumstances. That is real consumer expenditures in May, in the *Personal Income and Outlays* report to be published June 28 (just after this letter has gone to the printer).

As earlier elucidated, the numbers for the first four months of 2004 have been unusually weak. Overall growth was \$61.5 billion, or \$184.5 billion at annual rate. This compares with an annualized increase in the fourth quarter of 2003 by \$388.4 billion and an increase over the whole year by \$297.7 billion. To speak of any traction in this economy is absurd. With the mortgage-refinancing bubble seriously jeopardized, more weakness is the only thing we can imagine for consumer spending.

## **UNWINDING — A HAZARDOUS TASK**

The other bubble that gives us the greatest headache is the highly leveraged carry trade in longer-term bonds. We ask ourselves how this monstrous bubble, having certainly run into several trillion dollars, can ever be unwound without pushing market interest rates substantially upward.

To understand the problem looming in this bubble, just think of Long-Term Capital Management's (LTCM) calamity in 1998. At the time of trouble, the hedge fund had an exposure of about \$1.25 trillion, with 95% or more of the money borrowed.

At the decisive meeting of the bankers, it was declared that in the case of disorderly unwinding, those represented in the room, all of them major lenders to LTCM, might suffer a capital loss of \$20 billion. A fire sale of unimaginable proportions could begin, with prices crashing and everyone rushing to the doors at once.

Well, prices of longer-term bonds crashed in April–May. For 10-year bonds, the loss was close to 10%. For the time being, U.S. bonds have stabilized at their lowered level, as unwinding — in other words, selling — has drastically abated or stopped. But it is a deceptive stability. Such a huge bubble that has been built up over two or three years is not liquidated within weeks. For sure, the bulk of the carry trade still hangs over the markets.

The decisive point to see about the carry trade of bonds from a macro perspective is that huge purchases of bonds

with borrowed money essentially result in artificially low longer-term interest rates. Normally, such purchases ought to come exclusively from current savings.

While the U.S. economy has near-zero domestic savings, it possesses a financial system that, thanks to its central bank, knows no limit in credit and debt creation. It is a financial system of virtually unlimited “elasticity,” one might say.

However, this extraordinary financial elasticity works overwhelmingly in two directions: personal consumption and financial speculation. During the 13 quarters from end-2000 to the first quarter of 2004, private household debt has soared by \$2.52 trillion, or 36%, and financial sector debt by \$2.9 trillion, or 35%. Jumping from \$578.1 billion in 1980 to \$11,280.6 billion in the first quarter of 2004, the debt of the financial sector in the United States has skyrocketed from 21% of GDP to 98.4%.

Mr. Greenspan keeps hailing this extraordinary ability of the U.S. financial system for expansion as a sign of superior efficiency. We increasingly wonder about its elasticity in the opposite direction, that is, when it comes to unwinding existing bubbles, regarding the immediate surge of long-term interest rates only as a first taste of things to come.

Building the huge carry-trade bubble of bonds during the past few years has been fun because the yield spread and rising bond prices lured ready buyers en masse. It was a pleasure for sellers and buyers. But we wonder from where the huge buying of bonds will come when selling pressure from the unwinding of this bubble will develop in earnest.

Imagine, America’s whole financial system has trillions of dollars in the same boat. But what can possibly trigger heavy selling of this kind? For sure, the Fed is desperate not to upset this boat with the major rate hikes that could do so. If it feels compelled to move in order to satisfy bond vigilantes, it will do no more than minimal, so to speak, rather symbolical rate hikes.

As pointed out earlier, the danger lurks in the interest rates that the market determines. What triggered the first selling wave in the bond market was the worsening news about inflation and the good news about employment. For the reasons explained, we expect worsening news about the economy. Regarding inflation rates to be heavily manipulated to the downside, we hesitate to say anything about inflation.

A weakening economy would, certainly, tend to diminish the immediate urge to unwind leveraged bond positions. But the market will have to accommodate new issues of all kinds of bonds. Just think of the government’s big deficit.

While unwilling to sell its leveraged bond holdings at falling prices, financial institutions may be just as unwilling to buy new bonds at existing rates. Invariably, longer-term interest rates rise, and when that happens, it is also sure to trigger selling from the leveraged portfolios. Invariably, interest rates rise.

Considering the huge amounts involved in the U.S. carry trade, we think that this bubble has, actually, become far too big to allow for orderly unwinding, by which we mean unwinding with moderate interest effects. Under the conditions created by the Fed, it was easy to create virtually unlimited leveraged buying of bonds on the way up. But there are few willing buyers on the way down.

But to be sure, it is impossible to recreate these conditions. *First of all*, rate cutting by the Fed has spent its power; *second*, there will be upward pressure on interest rates from new credit demand; and *third*, being outrageously overloaded with highly leveraged bond holdings, the financial system will be a very reluctant buyer of new bonds.

For many American economists there is always a “buyer of last resort” at hand, endowed with the infallible ability to solve all problems in a painless way: the central bank, in the U.S. case the Federal Reserve. If the bond selling finds no buyers, the central bank simply steps in, printing money.

To recall, this was already seriously discussed last summer, loudly propagated in particular by the Fed’s Ben Bernanke. We always wondered whether he really knew what he was talking about. The thing to see is that to substantially influence long-term rates in today’s huge bond markets would require interventions at a scale for which there is no room on any central bank’s balance sheet.

Not to forget also, in its efforts to lower long-term rates, the Fed enjoyed tremendous help from unprecedented bond purchases from foreign central banks last year, pouring more than \$300 billion into Treasury and agency bonds. For several months now, these purchases have completely stopped.

*All in all, the asset bubbles have over time become far too big to allow for orderly unwinding. With the highly leveraged carry trade in bonds alone running into several trillions of dollars, one has to wonder where and who the necessary potential buyers for these trillions are that would make such extensive deleveraging possible. The fact to see is that the Greenspan Fed has lured the U.S. financial system into a horrible liquidity trap.*

Strictly speaking, all asset markets in the United States are, in essence, inflated bubbles. Mr. Greenspan has repeatedly stressed in public the difficulty, if not the impossibility, of identifying a bubble. For a central banker, that is a shame. Such bubbles have several characteristics that are easily identifiable.

## **A NEW PARADIGM MONETARY POLICY**

Implicitly, bubbles are overwhelmingly propelled by borrowed money. Asset bubbles and credit bubbles always go together, the latter being the substitute for savings. This was as clear as daylight during the late 1990s, with corporations borrowing mainly for mergers, acquisitions and stock buybacks.

Last year's stock market recovery, on the other hand, benefited crucially from the hundreds of billions of dollars that private households extracted from their homes through the mortgage-refinancing binge. Given such extreme borrowing excesses, it is a simple logical conclusion that U.S. interest rates must be far too low.

Another one of Mr. Greenspan's arguments in glossing over the extreme credit excesses he created is that financial imbalances cannot be identified with any sufficient degree of certainty. It used to be a truism in economics that credit expansion should not exceed available savings. Basic to this concept is the idea that savings from current income, implicitly reflecting diminished consumer spending, has to make the real resources available for investment. In the United States, a total credit expansion of \$2.7 trillion in 2003 compared with net national savings of \$174 billion. That is more than an imbalance between the two; that is an abyss.

But instead of funding capital investment, America's unbelievable credit deluge of the past few years poured overwhelmingly into two other channels: soaring imports and soaring financial speculation driving up asset prices. In today's conventional American perception, the U.S. economy has become wealth driven, in contrast to the traditional income-driven pattern.

The capital value of any asset is principally determined by current income capitalized at the current interest rate. It has been one of the outstanding characteristics of the new monetary policy that asset prices — stocks, bonds and housing — in the United States soared across the board to unprecedented levels. The obvious underlying cause was artificially low interest rates. Putting it more bluntly, the massive downward manipulation of interest rates translated into massive upward valuation of capital values.

All this leaves us with the truly cardinal question of whether these new paradigm policies and the resulting economic development have created the necessary conditions for a healthy, sustained economic recovery. The favorite argument of the bullish consensus is that it has in the first place generated a milder recession than has been normal.

That was in 2001. This policy is now in its fourth year. Pondering its success or failure, it appears a self-evident necessity to judge the economy's performance over this full period. Compared with recoveries after past postwar recessions, it has been disastrous by any macro measure — GDP, employment or income.

For perspective: In terms of real GDP growth, the present U.S. economy's recovery over its first 29 months has been more than 50% slower than the average past postwar recovery. Employment growth differs like day and night. Real private wage and salary disbursements over this period have risen a little less than 3%, compared to an average gain of 9% in the previous six economic upturns.

The salient features of the recoveries immediately following a recession were extraordinary gains in employment, wage and salary income and industrial production. Within two years, the three aggregates regularly reached levels well above their pre-recession peak. The recessions ended in accelerating growth. Manifestly, the present recovery lacks all the internal dynamics common to those of the past.

## ILLUSIONS ABOUT PROFITS AND INVESTMENT

The apparent general great hope now is that American businesses have finally started their great hiring and investment-spending spree that has been typical of past recoveries. A main argument is that tenacious corporate cost cutting has been rewarded with record-high profits. Below are profit figures reported in the BEA's National Income and Product Accounts (NIPA) data. As always, we like to see things in the longer-term perspective, and also in more detail.

For sure, profits have sharply recovered from their recession lows. But the trouble is that this rebound grossly lags the prior plunge. Annualized profits in the first quarter of 2004 were 20% below their peak in 1997. But to make the two figures comparable, we ought to take the interim growth in GDP into account. In 1997, the profits of the nonfinancial sector equaled 6.1% of nominal GDP. But in 2003, this ratio was sharply down to 3.7%. In the light of these numbers, the trumpeted profit miracle definitely looks more like a profit debacle.

CORPORATE PROFITS (IN BILLIONS OF U.S. DOLLARS)								
	1997	1998	1999	2000	2001	2002	2003	2004 I
NONFINANCIAL	508.4	470.1	461.1	413.4	318.8	334.3	410.0	403.9
MANUFACTURING	209.0	157.0	150.6	144.3	54.0	73.3	96.6	
MOTOR VEHICLES	4.8	6.4	7.3	-1.0	-7.2	-1.0	1.1	
MACHINERY	16.7	15.6	12.4	8.2	3.2	1.5	-2.6	
COMPUTERS	25.3	3.9	-6.5	4.0	-49.4	-18.4	-2.6	
RETAIL TRADE	64.2	66.4	65.2	59.6	71.1	76.7	80.1	

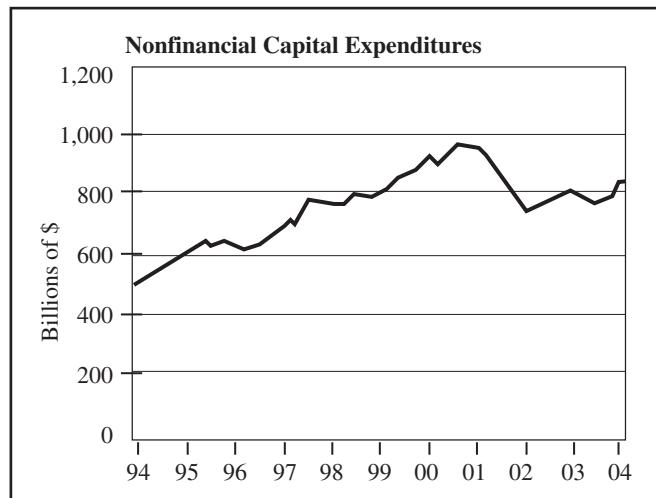
SOURCE: BUREAU OF ECONOMIC ANALYSIS, COMMERCE DEPARTMENT, SURVEY OF CURRENT BUSINESS

This profit picture differs tremendously from the bright picture generally reported for an obvious, simple reason. The admired profit miracle is in the financial sector, enjoying the carry trade and other easy and opulent profit sources. But looking for clues about economic activity, our focus is strictly on the profits made in the nonfinancial sector, where this activity takes place.

Earlier we pointed out that manufacturing is the sector in the U.S. economy that has fared worst of all. During 1997–2003, overall real GDP growth of 25.6% compared with an increase in overall industrial production by 8.7%. Its strongest component by far was consumer durables, with a rise of 21%. That is, of course, where the consumer borrowing and spending binge has raged. Manufacturing is plainly being crowded out of the U.S. economy.

Hardly astonishingly, manufacturing's profit performance has been and continues to be most dismal. In 2003, corporate earnings were up 79% from their recession low in 2001, but this fabulous growth rate in percentage conceals the fact that the 2003 level was less than half of that in 1997. Strikingly, such sectors as motor vehicles, machinery and computers show a dramatic deterioration in their profit performance.

It is argued that booming profits will stimulate a corporate hiring and investment boom. Since we do not see the booming profits, we are understandably more than doubtful about the hiring and investment effects. Yes, nonresidential business fixed investment has recovered from its slump in 2001–02, but it is a weak and extremely lopsided recovery. Its rise has entirely been in high tech. Investment in industrial and transportation equipment has remained flat. This is definitely not the kind of investment recovery that could possibly become the economy's new driver.



## **CONCLUSIONS:**

Rather abruptly, it has become the consensus view that a full-scale economic recovery with strong employment growth is definitely on its way in the United States. In general, the sudden sharp increase in job creation, up 947,000 over just three months, March through May, is seen as conclusive proof.

First of all, we don't buy the job numbers. Fully 618,000, or 65%, of this job creation is based on the Labor Department's assumption that in a recovery lots of new jobs are created outside its fixed survey. All it needs to activate this statistical job creation is its unilateral decision that the U.S. economy is in a recovery. Its corresponding estimate appears in its monthly employment reports under the title "net birth/death ratio."

In our view, presenting the public with such an estimate of suddenly bursting job creation after three years of recovery with massive job losses would rigorously require some explanation about the underlying assumptions.

But our flat disavowal of the optimistic recovery forecasts has other reasons. One arises from our very different reading of the economic data. The single most important factor is the drastic slowdown of consumer spending. Based on the official monthly data, consumer spending in the first four months of 2004 has risen \$184.5 billion, annualized. This compares with growth of \$388.4 billion in the fourth quarter of 2003 and \$364 billion in the third quarter, both annualized.

It was always the key question about the U.S. economy, whether the massive monetary and fiscal stimulus in the second half of last year would carry over into 2004. In the case of consumer spending, it definitely has not.

Our second critical observation concerns the movements in consumer durables, business fixed investment and residential building. As pointed out, they are the key dynamics in the business cycle, leading upturns as well as downturns. Past recessions, resulting from tight money, always ended with large cushions of pent-up demand in these components. This time, extremely loose money has had the opposite effect of borrowing from the future.

Third in our critical observations are the asset and credit bubbles that have been the main support to consumer spending. They have clearly lost their power. Everything now depends on rapidly rising employment and income creation. We do not see how this is possible in the face of sharply slowing economic growth.

There is a lot of talk that the Fed should aim to return its fed funds rate to "normal," 3%, as the forward rates are implying. But it would collapse all the asset bubbles it has systematically created; in other words, it would collapse trillions of dollars of market values.

A first round of the unwinding of the carry trade took place in April and May. It boosted the long-term rate by close to 1 percentage point. Yet despite all the talk about unwinding, this was only the tip of the iceberg. Outstanding positions are still enormous. More unwinding will further raise longer-term interest rates, no matter how weak the economy is.

## **THE RICHEBÄCHER LETTER**



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